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SUPREME COURT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. ~~1353~~ 126

JEROME S. MURRAY AND GRACE H. MURRAY, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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TABLE OF CONTENTS

	Page
Opinions Below	1
Jurisdiction	2
Questions Presented	2
Statutes Involved	3
Statement	3
Reason for Granting the Writ	6
Conclusion	14
Appendix A	1a
Appendix B	3a
Appendix C	4a
Appendix D	8a

CITATIONS

Cases:

Arrowsmith v. Commissioner, 344 U.S. 6	8, 9, 10
Binda, Robert, 22 T.C.M. 1195	13
Campagna v. United States, 290 F. 2d 682	8
Cohen v. Commissioner, 266 F. 2d 5	10
Commissioner v. Adam, Meldrum & Anderson Co., 215 F. 2d 163	8
Commissioner v. Gillette Motor Co., 364 U.S. 130	6
Commissioner v. Riss, et al., ... F. 2d ..., 67-1 USTC ¶ 9292	10
Corn Products Co. v. Commissioner, 350 U.S. 46	6
Duveen Bros., Inc. v. Commissioner, 197 F. 2d 118	8
Fink, Scott, 23 T.C.M. 475	13
Fulton Container Co. v. United States, 355 F. 2d 319	10
Gordy, Ralph E., 36 T.C. 852	13
Helvering v. Taylor, 293 U.S. 507	10
Kaufman v. Commissioner, 372 F. 2d 789	10
Kelly v. Everglades Drainage District, 319 U.S. 415	10

	Page
Malat v. Riddell, 383 U.S. 569	2, 5, 6, 7, 8, 11, 12
Municipal Bond Corp. v. Commissioner, 341 F. 2d 683	10, 13
Robert Louis Stevenson Apartments, Inc. v. Commissioner, 337 F. 2d 681	10
Scheuber v. Commissioner, 371 F. 2d 996	6, 7, 8, 10, 12, 13
Seven Canal Place Corp. v. Commissioner, 332 F. 2d 899	10
Tibbals v. United States, 362 F. 2d 266	14
Welch v. Commissioner, 297 F. 2d 309	10
Wener v. Commissioner, 242 F. 2d 938	8
STATUTES:	
Internal Revenue Code of 1954:	
Section 1221	3, 6
Section 1234	3
Section 7213(a)(1)	14
18 U.S.C. § 1905	14
28 U.S.C. § 1254(1)	2
MISCELLANEOUS:	
Mertens, Law of Federal Income Taxation, 1966 Revision:	
Section 22.24	8
Section 22.97	8
Treasury Decision 4945 (1939-2 Cum. Bull. 97)	14
Revenue Ruling 58-120 (1958-1 Cum. Bull. 498)	14

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The petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit in this case.

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court of the United States appear at R. 6-71.[1] The opinion of the Tax Court is not officially reported

[1] "R" references are to the Appendix to the petitioners' brief in the Court of Appeals (Vol. I of Transcript of Record).

but unofficially appears at 24 T.C.M. 762. The opinion of the Court of Appeals (Appendix A, *infra*, page 1a) is reported at 370 F.2d 568.

JURISDICTION

The judgment of the Court of Appeals was entered on January 6, 1967 (Appendix B, *infra*, page 3a). The petition for rehearing (Appendix C, *infra*, page 4a) filed by petitioner was denied February 7, 1967 (R, Vol. III, page 23). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the sales of unimproved property and interests therein qualify as capital gain transactions under the principles enunciated in *Malat* v. *Riddell*, 383 U.S. 569.

2. Whether the character of a transaction, as determined for the year of sale, controls as to subsequent collections under the installment method of reporting.

3. Whether the findings of fact support the conclusion that the taxpayer "was also engaged in the business of dealing in real estate and/or contractual interests therein during the years involved in these proceedings" (T.C. Op., R. 48).[2]

4. Whether the Tax Court was correct in holding that its conclusion, set forth in question 3, *supra*, "is buttressed by a consideration of the activities in this field of Stewart's Corner, a corporation wholly owned and controlled by Murray" (R. 50-51).

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[2] Immediately preceding this quotation, in the same sentence, it is stated "In the instant cases we accept petitioner's contention that he was an investor in real estate but we conclude, contrary to petitioner's contentions, that he * * *" (R. 48).

STATUTES INVOLVED

The pertinent provisions of Sections 1221 and 1234 of the Internal Revenue Code of 1954 are set out in Appendix D, *infra*, page 8a.

STATEMENT

The petitioners are husband and wife residing in Annapolis, Maryland. They filed joint Federal income tax returns for the years herein involved with the District Director of Internal Revenue, Baltimore, Maryland (R. 8).

The assets sold were the Gordon Contract (R. 23-27, 51-54); the Berry Option (R. 36-38, 55-56); and the "Adams" or "Potomac" Property (R. 46, 70).

In the Tax Court each of the years 1957-1961 was involved by reason of deficiencies asserted by the Commissioner (R. 6). Under the Tax Court decision the only deficiencies found to be due were for the years 1959 and 1961 (R. 82), and accordingly the appeal to the Circuit Court involved only those years. On appeal the issues were confined to the character, for tax purposes, of collections received in those years by reason of sales made in earlier years. The sale of the Gordon Contract occurred in 1955, and the taxpayer had held that contract for a period of two years and four months (R. 13). The Berry Option was sold in 1956 and had been held by the taxpayer for nine months (R. 15). Both of these sales were reported, and accepted by the Commissioner in the year of sale, as sales of capital assets. The Adams or Potomac Property had been held three years and four months and was sold in 1958 (R. 13). The Gordon Contract was sold as the result of an unsolicited offer to purchase (R. 25-26), and the

taxpayer was passive as to the sale of the Berry Option (R. 37, 97, 102).

Other properties were in dispute before the Tax Court. The taxpayer's position that some of those sales involved properties held for investment was sustained, primarily on the ground that they had produced rental income.[3] The three properties here involved were denied capital gain treatment by the Tax Court, primarily on the ground that they produced no rental or other income, or that no improvements, looking to the production of rental income, had been made.[4]

[3] Georgetown Univ. property (R. 41-42, 62); 1620 Wilson Blvd. (R. 45, 71); 301 Broad St. (R. 46, 71). In connection with the Holmes Bakery property, the taxpayer was credited with making bona fide efforts to lease it, though unsuccessfully (R. 56-57).

[4] Gordon Contract (R. 53); Berry Option, following holding re Gordon Contract (R. 55). The importance which the Tax Court attached to rental income (or lack of it) in determining the character of the sale is manifest from the following excerpt from the opinion (R. 69-70):

> • • • On the precise question involving the proper characterization of particular pieces of real estate (or contractual interests therein) as investments or properties held primarily for sale, we have already indicated our view that important factors are the receipt by the taxpayer during the time he holds the property of substantial rentals from the property or the receipt of rentals over a long period of years or the taking of steps which clearly indicate the intention of the taxpayer to use the property for the production of rental income, such as, for example, the making of substantial improvements thereon. The presence of these factors would indicate that the property was acquired and held as an investment. With regard to the three properties here involved, none of these factors is present.

Notwithstanding the specific findings of the Tax Court leading to the opposite conclusion,[5] the Tax Court, though accepting the petitioner's contention that he was an investor in real estate (R. 48), held that the taxpayer was also in the real estate business, and that the three assets involved herein were sold by him in the capacity of a real estate dealer.

In the Court of Appeals the petitioners urged, *inter alia,* that the Tax Court's findings of evidentiary facts failed to support the conclusion that the taxpayer was a real estate dealer during the years involved; that the items in controversy were determined to have been held primarily for sale to customers in the ordinary course of his business, notwithstanding the principles annunciated in *Malat* v. *Riddell, supra;* that the character of the sale, as determined for the year in which it occurred, fixed the character for all subsequent collections incident thereto; that the Commissioner's action in treating collections in later years in a manner inconsistent with the character of the transaction in the year of sale was arbitrary and capricious, the effect of which was to put the burden of proof on the Commissioner; and that the Tax Court had further erred in holding

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[5] * * * Prior to 1940 a part of petitioner's activity in the real estate business was that of a real estate broker. While he ceased to act as a real estate broker in the purchase and sale of real estate he retained his real estate broker's license until 1955 since he was advised that such a license was necessary in order to enable him to collect rents. During the years here in issue Murray was not listed in the telephone directory as a real estate broker, and he belonged to no association in any way connected with the real estate business. He did no subdividing. Other than in 1956 when a bank to which he was indebted required him to reduce his indebtedness, he had no "for sale" signs on any of his properties, and he did not advertise them for sale. (R. 9)

that the principal factor in determining whether an asset was held primarily for sale to customers in the ordinary course of business was the absence of rental or other income from the property.

The Court of Appeals rendered a brief *per curiam* opinion (Appendix A), affirming the Tax Court, on January 6, 1967, thereby giving blanket approval to the Tax Court's findings and opinion. The petitioners filed a petition for rehearing on January 26, 1967 (Appendix C) requesting reconsideration. The petition for rehearing was denied February 7, 1967, without opinion.

REASONS FOR GRANTING THE WRIT

1. Despite prior holdings involving capital gain transactions,[6] there remained doubt in the lower courts as to the proper interpretation of Section 1221(1) of the 1954 Code, in consequence of which this Court reviewed the problem in *Malat* v. *Riddell,* 383 U.S. 569. That opinion should have laid at rest any existing uncertainty as to the principles to be applied in determining whether a sale of property qualified for capital gain treatment. It is apparent that it did not, which accounts for the second reason for granting the writ.

2. The affirmance, *per curiam,* by the Fourth Circuit herein is in sharp conflict with a recent decision of the Seventh Circuit, *William A. Scheuber* v. *Commissioner,* decided February 2, 1967, 371 F.2d 996, reversing the Tax Court. There, as here, the evidentiary findings were in favor of the taxpayers, but the ultimate finding was against them. There, too, as here,

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[6] *Corn Products Co.* v. *Commissioner,* 350 U.S. 46, 52; 100 L.ed. 29, 35 (1955); *Commissioner* v. *Gillette Motor Co.,* 364 U.S. 130, 134, 4 L. ed. 2d 1617, 1621 (1960).

the gain from the sale was greatly in excess of cost. The Circuit Court, in *Scheuber,* reasoned that the profits "were unrealistically high for items held for resale in day to day operations of a business." In the instant case in the Gordon Contract, for example, the Tax Court found that taxpayer's gain on the entire transaction was $1,890,311.98 (R. 27). This sizeable gain must have been one of "the factors pertinent to this question which we have heretofore mentioned and discussed" (R. 54), in concluding that the Gordon Contract was held primarily for sale to customers in the ordinary course of taxpayer's business.

In *Scheuber* the Seventh Circuit noted that the Tax Court erroneously deprecated the guidelines favorable to the taxpayers in determining the character of the sale, citing as an example the Tax Court's conclusion that advertising and affirmative efforts to sell were unnecessary since a seller's market existed and because Mr. Scheuber was in the business of selling real estate. The Tax Court in the instant case manifestly held a similar view, but the Fourth Circuit approved it. Furthermore, the Seventh Circuit discerned a misapplication of the *Malat* principles in the emphasis laid on the facts that the taxpayer was in the real estate business, and that the properties involved had not been isolated from those held for sale.[7] Similar evidence of misapplication of the *Malat* principles is apparent in the case at bar (R. 13, 15), but the Fourth Circuit failed to take cognizance thereof.

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[7] Its opinion points out that the Malats were also dealers in real estate and operated on a much larger scale than the Scheubers. Here, as found by the Tax Court (R. 13), Murray's individual sales as shown by the returns for years pertinent to issues here involved aggregated 5 for 1955, 6 for 1956, 3 for 1957, 1 for 1958, 1 for 1959, and 3 for 1960 (2 being involuntary conversions; R. 42-43).

Obviously, the views of the Tax Court and the Fourth Circuit, in the case at bar, are poles apart from those of the Seventh Circuit in *Scheuber* as to the application of the *Malat* principles. The number of cases in litigation involving the character of sales of real property (significantly, largely confined to that category) indicates that the problem remains an important question of Federal law, which calls for further enlightenment by this Court.

3. Ever since this Court decided *Arrowsmith* v. *Commissioner*, 344 U.S. 6 (1952), it has been well established that in a transaction involving the sale or exchange of property, the character of the transaction is fixed at the time it occurs; and any subsequent transactions relating to the original sale or exchange partake of the same character.[8] Thus, for example, when the sale of the Gordon Contract in 1955 was reported, under the installment method, as a long-term capital gain transaction and was so accepted by the Commissioner,[9] any collections by the taxpayer pursuant to his installment method of reporting, must necessarily be of the same character.

In the Tax Court the petitioners urged that the approval by the Commissioner of the reporting of the sale in 1955 of the Gordon Contract, and the subsequent

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[8] *Campagna* v. *United States*, 2 Cir., 290 F.2d 682 (1961); *Wener* v. *Commissioner*, 9 Cir., 242 F.2d 938 (1957); *Commissioner* v. *Adam, Meldrum & Anderson Co.*, 2 Cir., 215 F.2d 163 (1954); *Duveen Bros., Inc.* v. *Commissioner*, 2 Cir., 197 F.2d 118 (1952); Mertens, *Law of Federal Income Taxation*, 1966 Revision, § 22.24, n. 6, 7 and § 22.97, n. 59.

[9] R. 22-23, 27, 51. In fact the Commissioner recomputed the capital gain tax for 1955, and made a refund on that account (R. 78).

refund resulting from the Commissioner's recomputation of the amount of capital gain, had the same degree of finality as is accorded a determination of a deficiency from which no appeal is taken. On that premise it was further urged that in later years where collections were received by the petitioners under the installment method of reporting income from said sale, the action of the Commissioner in treating such collections as ordinary income was inconsistent with his treatment of the sale of the Gordon Contract as a capital gain transaction in 1955, since in the intervening years there had been no change in the law and no change in the facts concerning said contract. In response, the Tax Court held, "This argument is without merit" (R. 51). The opinion further states (R. 52):

> * * * As we have indicated above, the respondent made no "determination" with regard to petitioner's return for 1955 which would preclude us from considering on its merits the question of whether respondent erred in his determination in the instant cases that petitioner's net receipts from the Gordon Tract transaction constituted ordinary income rather than long-term capital gains, or would in any way affect the validity of the determinations of deficiency here involved.

In the Court of Appeals *Arrowsmith* v. *Commissioner, supra,* was relied upon in urging that the character of the sale was fixed in the year of sale, which character carried through to all subsequent transactions in connection therewith. As an alternate argument, the petitioners urged upon the Fourth Circuit, as they had in the Tax Court, that in any event it was an arbitrary action for the Commissioner to take an inconsistent position in the later years here involved, and that the effect thereof would be to place on the Com-

missioner the burden of proving that he was in error in treating the transaction in the year of sale as a capital gain transaction.[10] No claim of prior error was made by the Commissioner. It is implicit in the opinion of the Tax Court that it believed the burden of proof to be on petitioner throughout (R. 52-53).

The Commissioner's action, approved by the Tax Court and the Fourth Circuit, would permit the Commissioner, arbitrarily, to determine each year, as to each collection, whether it was ordinary income or capital gain. This is in direct conflict with the *Arrowsmith* principle, which, heretofore, has never been seriously questioned. The conflict was fully argued in the Court below but was not even mentioned in its *per curiam* opinion. The petition for rehearing (Appendix C) was based, in part, upon the failure of the Fourth Circuit either to discuss or to distinguish *Arrowsmith*.

4. The well established principle that an ultimate finding of fact should be supported by evidentiary findings[11] has not been followed in the case at bar. The specific findings of the Tax Court quoted in footnote

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[10] *Helvering* v. *Taylor*, 293 U.S. 507, 511-512 (1935); *Cohen* v. *Commissioner*, 9 Cir., 266 F.2d 5, 11 (1959); *Welch* v. *Commissioner*, 4 Cir., 297 F.2d 309, 311 (1961); *Herbert Kaufman* v. *Commissioner*, 4 Cir., 372 F.2d 789 (1966). *Cf. Seven Canal Place Corporation* v. *Commissioner*, 2 Cir., 332 F.2d 899, 901 (1964); *Robert Louis Stevenson Apartments, Inc.* v. *Commissioner*, 8 Cir., 337 F.2d 681, 687-688 (1964); *Fulton Container Co.* v. *United States*, 9 Cir., 355 F.2d 319, 324-325 (1966); *Commissioner* v. *Riss, et al.*, 8 Cir., — F.2d — (1967), 67-1 USTC ¶ 9292.

[11] *Kelly* v. *Everglades Drainage District*, 319 U.S. 415, 421-422, 87 L.ed. 1485 (1943); *William A. Scheuber* v. *Commissoner*, 7 Cir., 371 F.2d 996 (1967). *Cf. Municipal Bond Corporation* v. *Commissioner*, 8 Cir., 341 F.2d 683, 686 (1965).

5, *supra*, page 5, negate any conclusion that the taxpayer was a real estate dealer during any of the years pertinent to this case. Furthermore, the opinion of the Tax Court concedes that "In the instant cases we accept petitioner's contention that he was an investor in real estate * * *" but concludes that he also was "engaged in the business of dealing in real estate and/or contractual interests therein during the years involved in these proceedings" (R. 48). But where are the facts to support the conclusion that he was also engaged in the business of dealing in real estate or interests therein? It is submitted that instead of facts sufficient to sustain this conclusion, the Tax Court relied upon its preliminary conclusions that—

> (a) Rental or other income was an important factor in determining that a particular property was held for investment; and that the absence of rental or other income strongly indicated that it was held primarily for sale to customers in the ordinary course of his trade or business (R. 69-70).
>
> (b) The amount of profit ultimately to be realized from the sale was a strong indication that such property was being held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business (R. 13, 15, 27).

Both of these preliminary conclusions completely lack support from *Malat* v. *Riddell, supra,* and accordingly would be an unwarranted extension of the *Malat* principles. There, the presence or absence of rental or other income was not considered as a factor, much less an important one, in determining whether the property was held for "the realization of appreciation in value accrued over a substantial period of time."

383 U.S. at 572. And as to the large amount of profit resulting from the sale (R. 27), it merely evidences the realization of appreciation in value under the *Malat* principle, not the contrary conclusion that it is proof of the fact that the property was being held primarily for sale in the everyday operations of taxpayer's business. In *Scheuber, supra,* the Seventh Circuit noted the fallacy of the Commissioner's argument as to the implication which arises from substantial gains by pointing out that such gains would have been "unrealistically high for items held for resale in day to day operations of a business" (371 F.2d at 999). The Seventh Circuit's view is entirely consistent with *Malat.* In the instant case, the Tax Court and the Fourth Circuit held the opposing view.

When, in addition to the foregoing, there are considered the facts found by the Tax Court as to the number of sales, the period of holding of each, and the gain to the petitioner during the several years which are pertinent to this case (R. 13), as well as those sales made by two joint ventures of which petitioner was a member (R. 15), it would be difficult to conclude that the petitioner was in the everyday business of making sales to customers. And when we eliminate from that list the properties referred to in footnote 3, *supra,* also the three properties involving involuntary conversions, from which the petitioner realized long-term capital gains as found by the Tax Court (R. 42-45), such legal conclusion becomes even more tenuous, particularly in light of the absence of normal real estate activities (R. 9). It is apparent that the record does not contain facts sufficient to justify the conclusion that the petitioner was in the real estate business, or that he was holding primarily for sale the three properties herein involved.

5. At the trial of this proceeding the Tax Court admitted in evidence certain tax returns and records relating to a corporation which was wholly owned by petitioner (R. 5, 50-51, 126-127, 130, 158), but which has been recognized by the Government as a separate taxable entity (R. 126). This action was approved by the Fourth Circuit. The holding on this point is in direct conflict with *Municipal Bond Corporation* v. *Commissioner,* 8 Cir., 341 F.2d 683 (1965). That case involved a comparable situation in which the Circuit Court held in part (p. 691):

> * * * under the record here it appears that taxpayer is a separate and distinct corporate entity and no basis has been shown for piercing the corporate veil. Hence, it is our view that *the operations of the other corporations would have no probative force* in establishing taxpayer's purpose of holding real estate except to the extent that it might be shown that the other corporations were acting as an agent for the taxpayer. (Italics supplied; citations omitted.)[12]

Since the corporation involved in the instant case had sustained operating losses during most of the years involved, and since the Commissioner did not offset those losses against the taxpayer's income (R. 126), it is difficult to justify the Tax Court's attempt to "buttress" its conclusion (R. 50-51) by reference to the activities of this corporation (R. 10-12).

The Tax Court itself has held to the contrary in *Ralph E. Gordy,* 36 T.C. 852, 859 (1961), in *Scott Fink,* 23 T.C.M. 475, 480 (1964), and in *Robert Binda,* 22 T.C.M. 1195, 1203 (1963). The Court of Claims recently considered this problem, and in a divided opin-

[12] *Cf. Scheuber* v. *Commissioner, supra.*

ion; permitted such evidence to be considered. *Tibbals v. United States*, 362 F.2d 266, 272, 280 (1966).

Petitioners submit that the sanctity of Federal income tax returns filed by third parties is an important factor in the administration of the Internal Revenue Code;[12] and that this clear conflict between the Circuit Courts should also be resolved by granting this petition for certiorari.

CONCLUSION

For the foregoing reasons this petition should be granted.

Respectfully submitted,

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[12] That third-party returns are protected from public disclosure appears to be required by: 18 U.S.C. § 1905; § 7213(a)(1) of the Internal Revenue Code of 1954; § 463 D. 7 of Treasury Decision 4945 (1939-2 Cum. Bull. 97); and Revenue Ruling 58-120 (1958-1 Cum. Bull. 498).